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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

2002 JUL -8 P 2:14

AZ CORP COMMISSION
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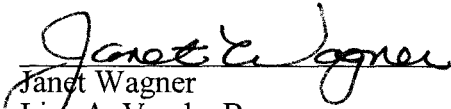
IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., FOR A COMPLETE WAIVER OF PUBLIC
UTILITY HOLDING COMPANIES AND
AFFILIATED INTERESTS RULES (A.A.C.
R14-2-801. *et seq.*) AND RELATED RELIEF

DOCKET NO. W-01303A-01-0983

STAFF'S NOTICE OF FILING

Staff of the Arizona Corporation Commission hereby files the Direct Testimony of Darron W. Carlson, Joel M. Reiker and John A. Chelus, of the Utilities Division, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 8th day of July, 2002.


Janet Wagner
Lisa A. VandenBerg
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402
e-mail: jwagner@cc.state.az.us

Original and ten (10) copies
of the foregoing filed this
8th day of July, 2002 with

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing was mailed
this 8th day of July, 2002 to

Norman D. James, Esq.
Fennemore Craig, P.C.
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012
Attorneys for Arizona-American Water Company, Inc.

Arizona Corporation Commission

DOCKETED


JUL - 8 2002

DOCKETED BY



1 Michael M. Grant
2 Gallagher & Kennedy
3 2575 East Camelback Road
4 Phoenix, Arizona 85016-9225

5 B. Kent Turner
6 Vice-President/Treasurer
7 Arizona-American Water Company, Inc.
8 880 Kuhn Drive
9 Chula Vista, California 91914

10 
11 Angela L. Bennett

**DIRECT
TESTIMONY**

OF

**DARRON W. CARLSON
JOEL M. REIKER
JOHN A. CHELUS**

**IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY
INC. FOR A COMPLETE WAIVER OF THE
REQUIREMENTS OF THE PUBLIC UTILITY
HOLDING COMPANIES AND AFFILIATED,
INTERESTS RULES (A.A.C. R14-2-801, *et seq.*)
RELATED RELIEF, AND NOTICE OF INTENT
TO REORGANIZE**

DOCKET NO. W-01303A-01-0983

JULY 8, 2002

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

IN THE MATTER OF THE APPLICATION OF)
ARIZONA-AMERICAN WATER COMPANY,)
INC. FOR A COMPLETE WAIVER OF THE)
REQUIREMENTS OF THE PUBLIC UTILITY)
HOLDING COMPANIES AND AFFILIATED)
INTERESTS RULES (A.A.C. R14-2-801, *et seq.*),)
RELATED RELIEF, AND NOTICE OF INTENT)
TO REORGANIZE.)
_____)

DOCKET NO. W-01303A-01-0983

DIRECT

TESTIMONY

OF

DARRON W. CARLSON

PUBLIC UTILITIES ANALYST V

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JULY 8, 2002

TABLE OF CONTENTS

Page

Introduction.....	1
General Information.....	2
Waiver of the Rules	3
Notice of Intent to Reorganize.....	4
Staff Recommendations	6

EXECUTIVE SUMMARY
ARIZONA-AMERICAN WATER COMPANY, INC.
DOCKET NO. W-01303A-01-0983

Arizona-American Water Company, Inc. ("AAWC") filed an application seeking a waiver of the requirements of the public utility holding companies and affiliated interests rules (A.A.C. R14-2-801, *et seq.*). Subsequently, AAWC filed an amendment to the application to include a notice of intent to reorganize.

The application applies to a specific reorganization, in which AAWC's parent, American Water Works Company, Inc. will be reorganized due to its purchase by Thames Water Aqua Holdings GmbH (a German holding company) a wholly-owned subsidiary of RWE AG (a German utility conglomerate). The application requests the following:

- (1) A waiver based on AAWC's contention that the reorganization will have no effect on AAWC, or
- (2) a waiver based on the lack of jurisdiction over AAWC's parent, or
- (3) approval of the reorganization, for which AAWC filed the notice of intent to reorganize.

Staff recommends approval of the reorganization, subject to certain conditions.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Darron W. Carlson. I am a Public Utilities Analyst V employed by the
4 Arizona Corporation Commission ("ACC" or "Commission") in the Utilities Division
5 ("Staff"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.
6

7 **Q. Briefly describe your responsibilities as a Public Utilities Analyst V.**

8 A. In my capacity as a Public Utilities Analyst V, I examine, verify, and analyze utilities'
9 statistical and other information and write reports based on my analyses that present Staff
10 recommendations to the Commission on mergers, acquisitions, asset sales, financings, rate
11 cases, and other matters. I also provide expert testimony in formal hearings before the
12 Commission on all of the aforementioned matters.
13

14 **Q. Please describe your educational background and professional experience.**

15 A. I hold a Bachelor of Arts degree in both Accounting and Business Management from
16 Northeastern Illinois University in Chicago, Illinois. I have participated in a number of
17 seminars and workshops related to utility rate-making, cost of capital, and similar issues,
18 sponsored by the National Association of Regulatory Utility Commissioners ("NARUC"),
19 Duke University, Florida State University, Michigan State University, New Mexico State
20 University, and others. I have lead or actively participated in over 110 cases before this
21 Commission.
22

23 **Q. What is the purpose of your testimony in this proceeding?**

24 A. The purpose of my testimony in this proceeding is to present Staff's position and
25 recommendations regarding the application of Arizona-American Water Company, Inc.
26 ("AAWC" or "Company") for a complete waiver of the requirements of the public utilities

1 holding companies and affiliated interests rules (A.A.C. R14-2-801, *et seq.*) ("Rules"),
2 that was dated and docketed on December 17, 2001. AAWC filed an amendment to
3 include a notice of intent to reorganize ("Notice") and requested certain related relief. The
4 amendment was dated and docketed on April 22, 2002.

5
6 **GENERAL INFORMATION**

7 **Q. What other Staff witnesses are involved in the presentation of Staff's**
8 **recommendations or have provided substantial relevant information that you relied**
9 **upon?**

10 A. I received assistance from the Commission's Consumer Services section and my
11 testimony will include any input received from that section. Mr. John A. Chelus is
12 providing Staff's pre-filed direct testimony regarding the engineering and technical
13 analysis. Mr. Joel M. Reiker is providing Staff's pre-filed direct testimony regarding the
14 financial analysis, cost of capital, and capital structure. You may see Mr. Reiker's
15 testimony for discussion of conditions #12 through #14, referred to on page 7 of this
16 testimony.

17
18 **Q. Please describe the reorganization that is the subject of this filing.**

19 A. The reorganization involves the purchase of AAWC's parent, American Water Works
20 Company, Inc. ("AWW"). RWE, AG ("RWE"), a German utility conglomerate, will
21 provide funds to its wholly-owned subsidiary, Thames Water Aqua Holdings GmbH
22 ("TWAH"), a German holding company, to purchase all, or substantially all, of AWW's
23 common stock. The stock purchase is expected to require approximately 4.6 billion
24 dollars. Additionally, TWAH will assume AWW debt of approximately 3.0 billion
25 dollars. Under terms of the agreement, AWW will become a wholly-owned subsidiary of
26 TWAH, by virtue of AWW's merger with Apollo Acquisition Company ("Apollo"), a

1 wholly-owned subsidiary of TWAH, created for the sole purpose of implementing the
2 agreement. After the merger of AWW and Apollo, the surviving entity will be AWW.
3 AAWC contends that all subsidiaries of AWW will be unaffected by this reorganization.
4

5 **Q. Are there any other entities that would be directly involved with AWW after the**
6 **merger?**

7 A. Yes, there is. TWAH is a holding company and has a wholly-owned subsidiary, Thames
8 Water PLC ("TWP"), an English corporation, that actually runs/operates all of TWAH's
9 water/wastewater utility systems. Additionally, AWW will run/operate all or most of
10 TWAH's water/wastewater utility systems in the Western Hemisphere, under the auspices
11 of TWP.
12

13 **WAIVER OF THE RULES**

14 **Q. Please describe AAWC's request for a waiver of the Rules.**

15 A. AAWC is requesting a complete waiver of the Rules based on its contention that the
16 reorganization will have no effect or impact on AAWC.
17

18 **Q. Under what criterion can the Rules be waived?**

19 A. A.A.C. R14-2-806 (A) reads, "The Commission may waive compliance with any of the
20 provisions of this Article upon a finding that such waiver is in the public interest."
21

22 **Q. Does Staff interpret the "public interest" to mean no harm or a benefit?**

23 A. Staff has determined that a benefit is necessary in order for a waiver to be in the public
24 interest.
25

1 Q. Did AAWC describe or demonstrate that the waiver request of the subject
2 reorganization is in the public interest?

3 A. AAWC did not specifically address how the waiver request is in the public interest.
4

5 Q. Did Staff attempt to demonstrate any measurable benefit as a result of the
6 reorganization?

7 A. Staff attempted to quantify any potential benefits through a number of data requests to
8 AAWC. The "benefits" discussed in AAWC responses were neither measurable nor
9 quantifiable. Staff repeatedly attempted to find some real benefit that was measurable and
10 that Staff was confident would come to fruition, but AAWC could not produce any
11 confirming data. In fact, an AAWC attorney stated in one later response, "I believe our
12 position has been pretty consistent: we don't expect any changes to take place in Arizona."
13

14 Q. When is the earliest time that quantification of the purported benefits may occur?

15 A. Typically, the Commission considers these kinds of issues in a rate proceeding. Staff
16 would need twelve months of operating data after the reorganization to evaluate the effects
17 of the reorganization. In other words, a rate proceeding based on twelve months of
18 operations subsequent to the reorganization is the earliest that quantification of the effects
19 of the reorganization could be reflected in rates.
20

21 **NOTICE OF INTENT TO REORGANIZE**

22 Q. Did AAWC file a notice of intent to reorganize?

23 A. AAWC's original filing only contained a request for waiver of the Rules. Pursuant to
24 discussions with Staff, AAWC filed an amendment to include the Notice on April 22,
25 2002.
26

1 **Q. What has Staff concluded from its review of the Notice and additional information**
2 **supplied by AAWC pursuant to data requests?**

3 A. Staff is concerned that AAWC implies that it will receive numerous benefits from the
4 reorganization, but has been unable to quantify any of the benefits in real or measurable
5 terms. Economies of scale do not always materialize, especially where efficient
6 operations already exist, as with AWW and AAWC.

7
8 Staff concludes that, after the reorganization, there will be no short-term changes in
9 AAWC, as it contends. However, Staff is concerned about long-term changes. The
10 general benefits of more expertise, access to more capital markets, and potentially higher
11 bond and credit ratings are real but not quantifiable according to AAWC.

12
13 **Q. What does the Commission consider when evaluating a notice of intent to**
14 **reorganize?**

15 A. Under A.A.C. R14-2-803 (C), "...the Commission may reject the proposal, if it
16 determines that it would impair the financial status of the public utility, otherwise prevent
17 it from attracting capital at fair and reasonable terms, or impair the ability of the public
18 utility to provide safe, reasonable, and adequate service."

19
20 **Q. Do you have any concerns about the acquisition of AWW by a holding company with**
21 **a large number of affiliates?**

22 A. It is possible that this acquisition may present the opportunity for AAWC to share
23 customer data, some of which may be sensitive, with its affiliates for business purposes.
24 This sort of information sharing may raise concerns about customer privacy. My
25 recommendations numbers 9 and 10 are intended to address these concerns.
26

1 **STAFF RECOMMENDATIONS**

2 **Q. What are Staff's recommendations?**

3 A. Staff recommends approval of the reorganization, subject to the following conditions:

- 4
- 5 1. AAWC shall not seek recovery of any excess of cost over book value paid pursuant to
- 6 the reorganization at anytime in the future from this Commission.
- 7 2. AAWC shall not seek recovery of any costs associated with the reorganization,
- 8 including internal corporate costs, in any future Arizona rate proceeding.
- 9 3. AAWC and its affiliates shall provide their books and records, upon request, in the
- 10 Phoenix metropolitan area. AAWC and its affiliates shall also provide access to their
- 11 books and records where such documents are maintained.
- 12 4. AAWC shall not adjust any existing account amounts as a result of the reorganization.
- 13 AAWC may make normal accounting adjustments that would have occurred absent the
- 14 reorganization.
- 15 5. Cost allocations and direct charges shall not increase due to the reorganization
- 16 including, but not limited to, the addition of layers of management.
- 17 6. AAWC shall not allow the reorganization to diminish local (Arizona) staffing that
- 18 would result in service degradation.
- 19 7. AAWC shall not allow its quality of service to diminish as a result of the
- 20 reorganization. The number of service complaints should not increase, the response
- 21 time to service complaints should not increase, and service interruptions should not
- 22 increase.
- 23 8. AAWC shall continue to maintain its current fully operational local (Arizona) field
- 24 service centers.
- 25 9. If AAWC ever plans to share with affiliates, or other entities, any information made
- 26 available to AAWC solely by virtue of the company/customer relationship, such as

1 billing information and services received by a customer, it shall notify the Commission
2 at least 180 days in advance. Such notice shall, at a minimum, identify the intended
3 use of the information. AAWC shall also, at the time of the filing of the 180-day
4 notice, file a tariff setting forth appropriate customer notification procedures to inform
5 customers about the sharing.

6 10. If AAWC ever shares any customer information with affiliates, or other entities, it
7 shall maintain accurate records of revenues earned as a result and make those records
8 available to Staff upon request with ten days notice.

9 11. AAWC shall not use utility assets for any unregulated activity without prior
10 Commission approval.

11 12. AAWC shall maintain a minimum common equity ratio of 35 percent of total capital.
12 AAWC's total capital is defined as common equity, preferred equity, and long-term
13 debt. AAWC shall not make remittances or pay dividends to AWW unless AAWC's
14 common equity is at least 35 percent of total capital. If AAWC's common equity falls
15 to 30 percent of total capital, AWW shall provide a cash infusion of equity sufficient
16 to bring AAWC's common equity ratio back to a minimum of 35 percent of total
17 capital.

18 13. The cost of debt for purposes of setting rates in AAWC's future rate proceedings shall
19 reflect a rating of A- (S&P) / Baa1 (Moody's) or higher.

20 14. AAWC and its affiliates agree that in future Commission proceedings, they shall not
21 seek a higher cost of capital than that which AAWC would have been authorized on its
22 own. Specifically, no capital financing costs (either debt or equity) should increase by
23 virtue of the reorganization.

24 15. AAWC shall refrain from filing any non-emergency rate increase requests for one year
25 from the closing date of the reorganization.
26

1 **Q. How do these conditions relate to the approval criteria of the waiver and the Notice?**

2 A. Conditions 1 through 14 are intended to ensure no harm. Condition 15 is intended to
3 provide a benefit. Conditions 12 and 13 could possibly be interpreted as providing some
4 benefit by maintaining AAWC's bond rating for rate-making purposes and by establishing
5 a common equity floor.

6
7 **Q. Which Staff witnesses are sponsoring these conditions?**

8 A. I am sponsoring conditions 1 through 11 and 15. Mr. Joel Reiker is sponsoring conditions
9 12 through 14.

10
11 **Q. Does this conclude your pre-filed direct testimony?**

12 A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

IN THE MATTER OF THE APPLICATION OF)
ARIZONA-AMERICAN WATER COMPANY,)
INC., FOR A COMPLETE WAIVER OF PUBLIC)
UTILITY HOLDING COMPANIES AND)
AFFILIATED INTERESTS RULES (A.A.C. R14-)
2-801 *et seq.*) AND RELATED RELIEF.)
_____)

DOCKET NO. W-01303A-01-0983

DIRECT

TESTIMONY

OF

JOEL M. REIKER

PUBLIC UTILITIES ANALYST V

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

JUNE 8, 2002

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
PURPOSE OF TESTIMONY	1
FINANCIAL IMPACT OF THE REORGANIZATION	2
Arizona-American's Anticipated Financial Benefits	2
Arizona-American's Access to Capital and Overall Cost of Capital	2
Arizona-American's Capital Structure	5
Recommended Conditions for Approval	6

EXHIBITS

Guide to Various Bond Ratings	JMR-1
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EXECUTIVE SUMMARY
ARIZONA-AMERICAN WATER COMPANY
DOCKET NO. W-01303A-01-0983

Arizona-American Water Company, Inc. ("Arizona American") filed an application seeking a waiver of the requirements of the public utility holding companies and affiliated interests rules (A.A.C. R14-2-801, *et seq.*). Subsequently, Arizona-American filed an amendment to the application to include a notice of intent to reorganize.

The application applies to a reorganization, in which Arizona-American's parent, American Water Works Company, Inc. will be reorganized due to its purchase by TWAH Water Aqua Holdings GmbH (a German holding Company), a wholly-owned subsidiary of RWE AG (a German utility conglomerate).

The direct testimony of Staff witness Joel M. Reiker addresses the anticipated financial impact that the acquisition of American Water Works Company, Inc. by TWAH Water Aqua Holdings GmbH will have on Arizona-American.

Mr. Reiker recommends placing conditions on approval:

1. Arizona-American shall maintain a minimum common equity ratio of 35 percent of total capital. Arizona-American's total capital is defined as common equity, preferred equity, and long-term debt. The Company shall not make remittances or pay dividends to AWW unless the Company's common equity is at least 35 percent of total capital. If Arizona-American's common equity falls to 30 percent of total capital, AWW shall provide a cash infusion of equity sufficient to bring Arizona-American's common equity ratio back to a minimum of 35 percent of total capital.
2. The cost of debt for purposes of setting rates in Arizona-American's future rate proceedings shall reflect a rating of A-(S&P)/Baa1(Moody's) or higher.
3. Arizona-American and its affiliates agree that in future Commission proceedings, they shall not seek a higher cost of capital than that which Arizona-American would have been authorized on its own. Specifically, no capital financing costs (either debt or equity) should increase by virtue of the reorganization.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Joel M. Reiker. I am a Public Utilities Analyst employed by the Arizona
4 Corporation Commission ("ACC" or "Commission") in the Utilities Division ("Staff").
5 My business address is 1200 West Washington Street, Phoenix, Arizona 85007.
6

7 **Q. Briefly describe your responsibilities as a Public Utilities Analyst.**

8 A. In my capacity as a Public Utilities Analyst, I provide recommendations to the
9 Commission on mergers, acquisitions, asset sales, and financings. I also perform studies
10 to estimate the cost of capital for utilities and recommend returns on equity.
11

12 **Q. Please describe your educational background and professional experience.**

13 A. In 1998, I graduated cum laude from Arizona State University, receiving a Bachelor of
14 Science degree in Global Business with a specialization in finance. My course of studies
15 included classes in corporate and international finance, investments, accounting, and
16 economics. In 1999, after working as an internal auditor for one year, I accepted a
17 position with the Commission's Utilities Division as an Auditor III. Since that time, I
18 have attended various seminars and classes on general regulatory and business issues,
19 including the cost of capital and the use of energy derivatives. I was promoted to my
20 current position in December of 2000.
21

22 **PURPOSE OF TESTIMONY**

23 **Q. What is the purpose of your testimony in this case?**

24 A. The purpose of my testimony is provide Staff's comments on the expected financial
25 impact that the acquisition of American Water Works Company, Inc. ("AWW") by
26 Thames Water Aqua Holdings GmbH ("TWAH") will have on Arizona-American Water

1 Company, Inc., ("Arizona-American" or "Company"), a subsidiary of AWW. I also
2 recommend placing conditions on approval.
3

4 **FINANCIAL IMPACT OF THE REORGANIZATION**

5 *Arizona-American's Anticipated Financial Benefits*

6 **Q. Does Arizona-American anticipate any financial benefit from the proposed**
7 **transaction?**

8 A. Yes. According to Arizona-American's application, the reorganization is likely to result
9 in increased access to capital, and may result in a reduction in the cost of capital to
10 Arizona-American.
11

12 **Q. Does Staff agree?**

13 A. The effect that the reorganization will have on Arizona-American is uncertain. While it is
14 possible that the reorganization may result in certain financial benefits to Arizona-
15 American, it is impossible to quantify the actual financial effect of the transaction at this
16 time.
17

18 *Arizona-American's Access to Capital and Overall Cost of Capital*

19 **Q. How does Arizona-American currently obtain capital?**

20 A. Arizona-American currently obtains debt financing from American Water Capital
21 Corporation ("AWCC"), a capital-lending subsidiary of AWW. Loans from AWCC to
22 Arizona-American are subject to review and approval by the Commission. Arizona-
23 American obtains additional funds in the form of common equity directly from AWW.
24

25 **Q. How would Arizona-American obtain capital after the reorganization?**

1 A. According to the Company's application, there will be no change in the relationship
2 between Arizona-American and AWCC as a result of the reorganization. Therefore,
3 Arizona-American would continue to receive debt financing from AWCC and equity
4 financing from AWW. However, RWE would, ultimately be the controlling entity that
5 dictates where and when capital would be supplied.

6
7 **Q. How could the proposed reorganization affect Arizona-American's capital costs and**
8 **ability to raise capital?**

9 A. Bond ratings affect debt financing costs; a higher bond rating usually reduces debt-
10 financing costs. Thus, the relative bond ratings of Arizona-American's parents before and
11 after the reorganization are indicative of how the cost of debt will be impacted. Because
12 Arizona-American would ultimately be an indirect subsidiary of RWE, Staff compared
13 RWE's bond ratings to those of AWCC. If RWE's bond ratings are lower than AWCC's,
14 then Arizona-American's cost of debt financing could increase as a result of a lowering of
15 AWCC's bond ratings following the transaction. If RWE's bond ratings are higher than
16 AWCC's, Arizona-American may obtain future debt financing at more reasonable terms.
17 RWE had higher bond ratings when it acquired Thames Water Plc ("TWP") in 2001. In
18 response to that transaction, Standard & Poors Corporation ("S&P") raised TWP's bond
19 rating from A+ to AA-.¹

20
21 **Q. Does RWE have a higher bond rating than AWCC?**

22 A. Yes. The following table shows RWE's Moody's and S&P bond ratings compared to
23 those of AWCC:²

¹ Company response to Staff data request DWC 3-18.

² Company response to Staff data requests DWC 3-16 and DWC 3-17.

Table 1³

	RWE	AWCC
Standard & Poors Corporation	AA-	A-
Moody's Investors Service, Inc.	A1	Baa1

As shown in Table 1, both S&P and Moody's Investors Service, Inc. ("Moody's") rate RWE's debt higher than AWCC's. As a result of the merger announcement between RWE and AWW, S&P placed AWCC's ratings on "positive outlook" and Moody's placed AWCC's ratings "under review for possible upgrade."⁴ On March 22, 2002, S&P placed RWE's ratings on CreditWatch with negative implications in response to RWE's announcement of its plans to acquire the U.K.-based electric supplier Innogy PLC ("Innogy"). Innogy's ratings were placed on CreditWatch with positive implications as a result of the announcement.

While it is uncertain how the reorganization will ultimately affect Arizona-American, based on RWE's bond ratings Arizona-American's access to capital markets could potentially increase due to a higher bond rating of RWE.

Q. Are there other reasons to expect Arizona-American to have increased access to capital markets as a result of the proposed transaction?

A. Yes. If the proposed reorganization is approved, Arizona-American will be part of a multinational corporation with a much larger market capitalization than AWW. This larger market capitalization might result in preferential treatment from creditors, thereby reducing its cost of capital. Second, multinational corporations can enjoy reduced flotation costs due to their relatively large issues of stocks and bonds.

³ See Exhibit JMR-1 for descriptions of bond ratings.

⁴ Company response to Staff data request JMR 4-24.

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Q. How will the proposed transaction affect the Company's overall cost of capital?

A. According to the Arizona-American's application and assertions by its representatives, the reorganization may result in a reduction in the cost of capital to Arizona-American.⁵

Q. Why does the proposed reorganization have the potential to lower the cost of capital to Arizona-American?

A. As stated above, RWE's favorable bond ratings may flow through to AWCC, lowering the cost of debt to AWCC and ultimately Arizona-American. Assuming all other things are held constant, a lower cost of debt to Arizona-American would result in a lower overall cost of capital in future rate cases.

Arizona-American's Capital Structure

Q. What is Arizona-American's current capital structure?

A. According to Arizona-American's December 31, 2001, Annual Report to the Commission, its capital structure consisted of approximately 58 percent debt and 42 percent equity.

Q. Is Arizona-American's capital structure similar to the average capital structure of larger, publicly traded water companies?

A. Yes. According to *Value Line Investment Survey*, the average capital structure of the publicly traded water companies it follows consisted of approximately 45 percent equity in 2001. The common equity ratio for the publicly traded water companies followed by *Value Line* ranged from 36 percent to 56 percent over the past five years.

⁵ Company's Amendment to Application for Waiver and Notice of Intent to Reorganize, p. 7 at 9-25.

1 Q. Will the proposed reorganization have any impact on Arizona-American's capital
2 structure?

3 A. According to the Company's application, the reorganization will have no effect on the
4 capital structure of Arizona-American. Arizona-American will not assume any debt or
5 other liabilities in connection with the proposed reorganization, nor will any costs or
6 obligations of any affiliates be allocated to Arizona-American. The Company stated that
7 Arizona-American will continue to have a common equity ratio of 40 to 45 percent equity.
8

9 **RECOMMENDED CONDITIONS FOR APPROVAL**

10 Q. Has Arizona-American been able to quantify any of the anticipated financial benefits
11 of the proposed transaction?

12 A. No, it has not. Arizona-American has stated that the proposed transaction will *likely* result
13 in increased access to capital and *possibly* a reduction in the cost of capital to Arizona-
14 American. However, international capital markets are ever-changing, making it
15 impossible to quantify the actual financial effect of the transaction. Under these
16 circumstances, Staff recommends that approval of the reorganization should be subject to
17 certifying its acceptance of certain conditions. These conditions are the following:
18

- 19 1. Arizona-American will maintain a minimum common equity ratio of 35 percent of
20 total capital. Arizona-American's total capital is defined as common equity, preferred
21 equity and long-term debt. The Company shall not make remittances or pay dividends
22 to AWW unless its common equity is at least 35 percent of total capital. If Arizona-
23 American's common equity falls to 30 percent of total capital, AWW shall provide a
24 cash infusion of equity sufficient to bring Arizona-American's common equity ratio
25 back to a minimum of 35 percent of total capital.

- 1 2. The cost of debt for purposes of setting rates in Arizona-American's future rate
- 2 proceedings shall reflect a rating of A-(S&P)/Baa1(Moody's) or higher.
- 3 3. Arizona-American and its affiliates agree that in future Commission proceedings, they
- 4 will not seek a higher cost of capital than that which Arizona-American would have
- 5 been authorized on its own. Specifically, no capital financing costs (either debt or
- 6 equity) should increase by virtue of the reorganization.
- 7

8 **Q. Does this conclude your direct testimony?**

9 **A. Yes, it does.**

TABLE OF CONTENTS

	<u>Page</u>
I. Introduction	1
II. Discussion	2

Standard & Poors Corporation Bond Ratings

AAA	Highest
AA	Very strong capacity to pay interest and repay principal.
A	Strong capacity to pay interest and repay principal.
BBB	Adequate capacity to pay interest and repay principal.
BB	Faces major ongoing uncertainties...which could lead to inadequate capacity to meet timely interest and principal payments.
B	Vulnerability to default but currently has the capacity to meet interest payments and principal repayments.
CCC	Currently identifiable vulnerability to default.
CC	Subordinated to CCC debt.
C	Subordinated to CCC- - debt.
CI	Income bonds on which no interest is being paid.
D	In default.

Plus (+)/Minus (-) The ratings from 'AA' to 'B' may be modified by the addition of a plus or minus sign to show relative standing within the major ratings categories.

Moody's Investors Service, Inc. Bond Ratings

Aaa	Judged to be of the best quality.
Aa	Judged to be of high quality by all standards.
A	Possess many favorable investment attributes and are to be considered as upper medium grade obligations.
Baa	Considered as medium grade obligations.
Ba	Judged to have speculative elements.
B	Generally lack characteristics of the desirable investment.
Caa	Are of poor standing.
Ca	Speculative in a high degree.
C	Lowest rated class of bonds.

Moody's applies numerical modifiers 1, 2, and 3 in each generic rating classification from Aa through B. The modifier 1 indicates that the company ranks in the higher end of its generic rating category.

Fitch Investors Service, Inc. Bond Ratings

AAA	Bonds considered to be investment grade and of the highest quality.
AA	Bonds considered to be investment grade and of very high credit quality.
A	Bonds considered to be investment grade and of high credit quality.
BBB	Bonds considered to be investment grade and of satisfactory credit quality.
BB	Bonds are considered speculative.
B	Bonds are considered highly speculative.
CCC	Bonds have certain identifiable characteristics which, if not remedied, may lead to default.
CC	Bonds are minimally protected.
C	Bonds are in imminent default.
DDD, DD, and D	Bonds are in default on interest and/or principal payments.

Plus (+)/Minus (-) Plus and minus signs are used with a rating symbol to indicate the relative position of a credit within the rating category.

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

IN THE MATTER OF THE APPLICATION OF)
ARIZONA-AMERICAN WATER COMPANY,)
INC. FOR A COMPLETE WAIVER OF PUBLIC)
UTILITY HOLDING COMPANIES AND)
AFFILIATED INTEREST RULES A.A.C. R14-2-)
801 ET. SEQ. AND RELATED RELIEF)

DOCKET NO. W-01303A-01-0983

DIRECT

TESTIMONY

OF

JOHN A. CHELUS

UTILITIES ENGINEER

UTILITIES DIVISION

JULY 8, 2002

**SUMMARY OF DIRECT TESTIMONY
OF JOHN A. CHELUS
ARIZONA-AMERICAN WATER COMPANY, INC.
DOCKET NO. W-01303A-01-0983**

1. All Company water and wastewater systems in the State are in compliance with Arizona Department of Environmental Quality and County regulations. All potable water systems are delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.
2. The Company has been proactive in preparing to meet the new Environmental Protection Agency arsenic standards of ten parts per billion which will take effect in the year 2006.
3. The Arizona Department of Water Resources ("ADWR") reported that the Company is in total compliance with ADWR reporting and conservation rules.
4. Engineering can not foresee any adverse impact as a result of this transaction that would impair the ability of the Company to provide safe, reasonable, and adequate service.

1 **INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. My name is John A. Chelus. My business address is 1200 West Washington Street,
4 Phoenix, Arizona, 85007.

5
6 **Q. By whom and in what position are you employed?**

7 A. I am employed by the Utilities Division of the Arizona Corporation Commission
8 ("Commission") as a Utilities Engineer.

9
10 **Q. How long have you held this position?**

11 A. Since September 1990.

12
13 **Q. What are your responsibilities as a Utilities Engineer?**

14 A. I inspect, investigate, and evaluate water and wastewater systems; obtain data, prepare
15 original cost studies, and investigative reports; suggest corrective action and provide
16 technical recommendations on water and wastewater system deficiencies; and provide
17 written and oral testimony on rate and other cases before the Commission.

18
19 **Q. How many water and sewer companies have you analyzed for the Utilities Division?**

20 A. I have analyzed 120 plus companies in various capacities for the Utilities Division.

21
22 **Q. Have you testified before the Commission previously?**

23 A. Yes, I have.

24
25 **Q. What is your educational background?**

26 A. I graduated from the Rochester Institute of Technology in 1976 with a Bachelors Degree
27 in Civil Engineering and from Oklahoma State University in 1978 with a Masters Degree
28 in Environmental Engineering.

1 **Q. Briefly describe your pertinent work experience.**

2 A. I worked for the Dallas Water Utilities as an engineer in the Wastewater Division, and
3 then in the Engineering Design Division from 1978 to 1981. I moved to Grand Junction,
4 Colorado and worked for Multi Mineral Corporation as a research engineer until 1982. I
5 then worked for Wastewater Engineering Consultants as a design engineer. In 1983, I
6 was employed by Sauter Construction as a construction engineer for the construction of
7 the Ute Water Treatment facilities in Palisade, Colorado. In 1984 and 1985, I was
8 employed by the City of Grand Junction as a Grade IV wastewater operator at their 12
9 million gallon per day activated sludge treatment facility. In 1986, I moved to Phoenix
10 and began working for the Arizona Department of Environmental Quality ("ADEQ"),
11 Office of Water Quality, as a design review engineer, and then as a field engineer. I
12 stayed at ADEQ until transferring to the Commission in 1990.

13
14 **DISCUSSION**

15 **Q. Were you assigned to provide an engineering evaluation of Arizona-American**
16 **Water Company Inc. for this proceeding?**

17 A. Yes.

18
19 **Q. What is the purpose of your testimony in this proceeding?**

20 A. The purpose of my testimony in this proceeding is to present the findings of my
21 engineering evaluation of Arizona-American Water Company, Inc. ("Company").

22
23 **Q. Are all of the Company's water and wastewater systems in compliance with the**
24 **Arizona Department of Environmental Quality ("ADEQ") and the Maricopa**
25 **County Department of Environmental Services ("MCDES") regulations?**

26 A. Yes. All Company water and wastewater systems in the State are in compliance with
27 ADEQ and County regulations. All potable water systems are delivering water that meet
28 water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

1 Q. Does the Company have any systems which will require additional treatment and/or
2 alternative water sources in order to meet the U.S. Environmental Protection
3 Agency ("EPA") new arsenic standard of ten parts per billion ("ppb") that must be
4 met by 2006?

5 A. Yes. The Tubac, Paradise Valley, Sun City West and Agua Fria systems have arsenic
6 levels that exceed the future 10 ppb standard.

7
8 Q. Has the Company taken steps to address the arsenic problem?

9 A. Yes. The Company completed an arsenic evaluation of all wells, performed cost analysis
10 studies, sent out informational flyers to all customers who will be affected by the new
11 standard, completed an arsenic removal pilot study at Sun City West in conjunction with
12 the American Water Works Association Research Foundation and the EPA, has begun
13 partnering in the City of Surprise arsenic pilot study at Roseview well, was represented in
14 the national arsenic cost study analysis by EPA and the National Drinking Water
15 Advisory Council ("NDWAC"), and is currently involved with the Arizona Arsenic
16 Master Plan hosted by ADEQ.

17
18 Q. Are the Company's water systems in compliance with the Arizona Department of
19 Water Resources ("ADWR")?

20 A. Yes. The ADWR reported that the Company is in total compliance with ADWR
21 reporting and conservation rules.

22
23 Q. Did you ask the Company if staffing levels will change for Arizona American as a
24 result of this transaction?

25 A. Yes. The Arizona-American President, Ray Jones stated in data response JAC5-37 that
26 no changes are anticipated at this time as a consequence of the transaction.

27 ...

28 ...

1 Q. Why is it important that Staffing levels be maintained?

2 A. In order for the Company to maintain adequate day to day reliability and high levels of
3 service, the operations staff and engineering staff levels should be maintained.
4

5 Q. From an engineering perspective, can you foresee any adverse impact as a result of
6 this transaction that would impair the ability of the Company to provide safe,
7 reasonable, and adequate service?

8 A. No.
9

10 Q. Does this conclude your testimony?

11 A. Yes, it does.
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